Taxes Over Santa

Trading Wisdom:

> *I have come to feel that it is as necessary to know how to read myself as to know how to read the tape. I have studied and reckoned on my own reactions to given impulses or to the inevitable temptations of an active market, quite in the same mood and spirit as I have considered crop conditions or analyzed reports of earnings.* ~ Jesse Livermore

This quote has been top of mind for me lately. We often like to think that we're different and our natural impulses are superior to the markets. But the truth is, the market is made up of millions of other Joes who are wired just like us, thinking the *exact* same thing.

It often helps to not only play the player but to also play yourself. Be aware of your own FOMO, greed, and fear of loss. Doing this, you find that you serve as a valuable market vane for sentiment extremes.

Data and Events in the week ahead:

It's a light week as far as economic data goes. The focus will be on the Republican tax bill and the passing of a funding bill to avoid a government shutdown.

The House is expected to vote on Tuesday, where it should easily pass. It will then be sent up to the Senate, where Republicans can only afford two dissenters and there's currently three uncommitted: Susan Collins, Jeff Flake and Mike Lee.

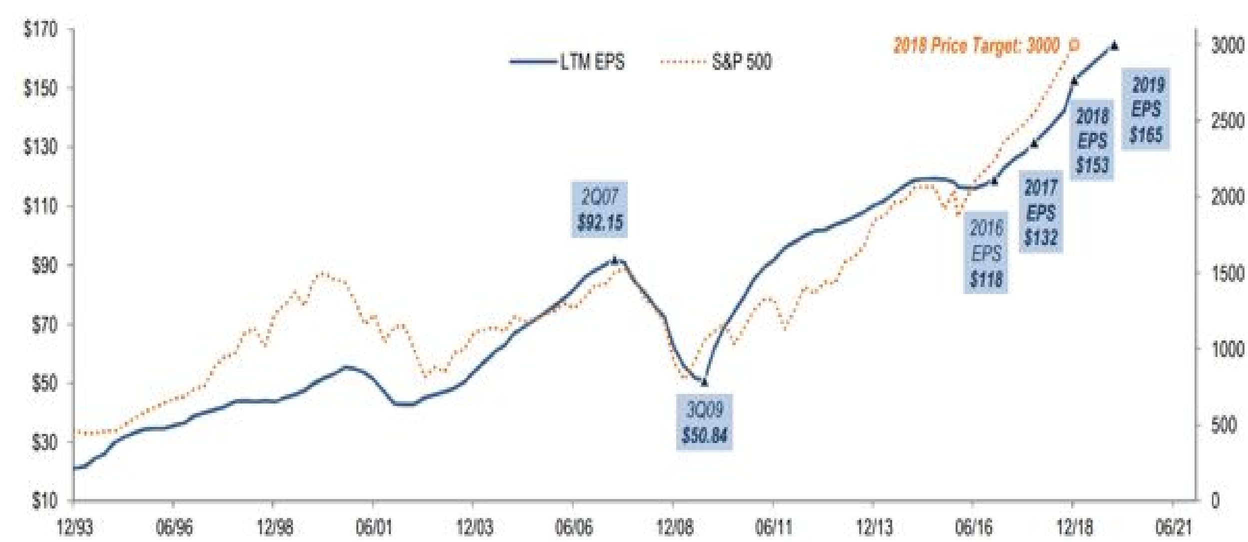
The gist of the tax bill is that it'll cut the corporate income tax rate to 21 percent, down from 35. Create a 20 percent business income tax deduction for owners of "pass-through" businesses and allow corporations to immediately write off new equipment costs, while also eliminating the corporate alternative minimum tax. It also establishes a new territorial system which will exempt US corporations from taxes on most future foreign profits as well as set a one-time tax on repatriation of foreign held funds.

If passed (and it likely will), it'll amount to an additional $10 in EPS for the S&P 500 next year. That's not small beans and its impact isn't fully priced into the market, yet. And if the repatriation of roughly $3T cash held overseas leads to another wave of corporate buybacks, then equities will have some strong tailwinds going into 2018. Here's JP Morgan's take on the tax reforms impact on the market.

> *Fundamentals should remain supportive with solid ~8% annual earnings growth for next two years with ~$10 EPS upside from tax reform. While we think S&P 500 earnings upside surprise will remain largely tied to scope and timing of the tax reform, our policy-neutral 2018 EPS estimate is $143 (+8% y/y vs. consensus of $146.21) and 2019 EPS of $155 (+8% y/y vs. consensus of $160.98). Including the ~$10 EPS benefit from tax (Senate Plan tax benefit of ~$9/share vs. House Plan at ~$11/share), we estimate 2019 Policy EPS of $165, which implies 25% EPS growth over next two years and cash flow growth should be even higher given immediate expensing of capital equipment. Additionally, the positive impact from low/middle-income household tax relief on consumption growth could drive further upside to EPS.*

Figure 1: S&P 500 performance has been closely linked to EPS growth in recent years

Actual EPS prior to 3Q2017, estimates thereafter



Source: J.P. Morgan US Equity Strategy & Global Quantitative Research.

Note: As I'm getting ready to send this out, news is breaking that Senator McCain is headed home to Arizona to be with his family. He's suffering from brain cancer and may not be coming back to D.C. This means Republicans are down one more yes vote on the tax bill, giving them an even narrower margin to work with.

MONDAY:

Monday opens the final week of trading before the Christmas holiday and we'll see inflation numbers print for the Eurozone.

TUESDAY:

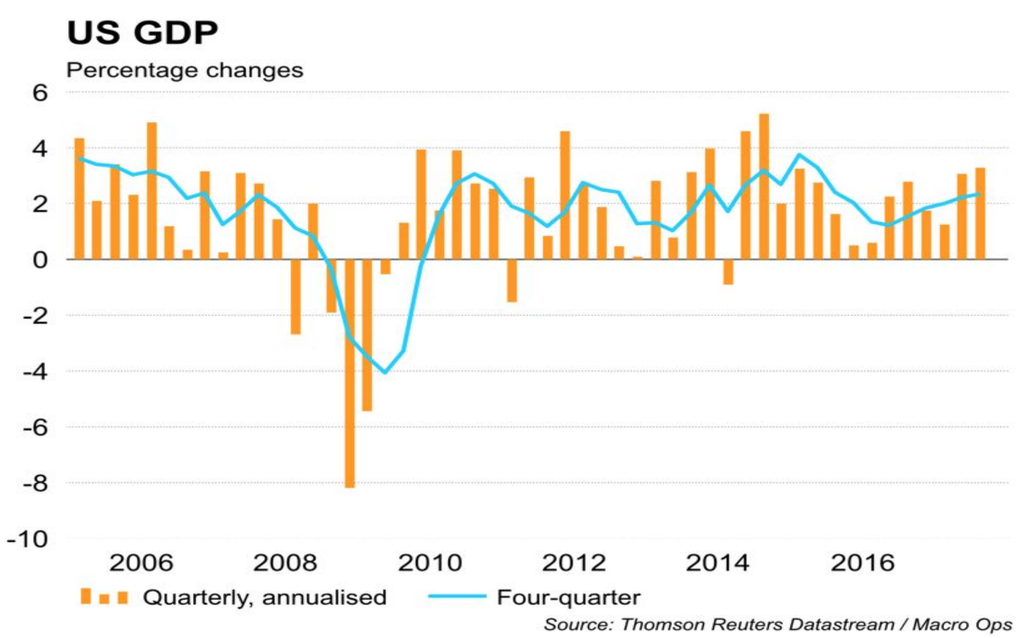
US Census Bureau releases November housing starts. Consensus calls for a decline to a 1.25 million annual rate.

WEDNESDAY:

The Swedish Central Bank meets and announces its interest-rate decision. Existing-home sales for the US are reported. Consensus is for an increase to a 5.53 million unit pace from 5.48 million in October. BoJ two day monetary policy meeting begins.

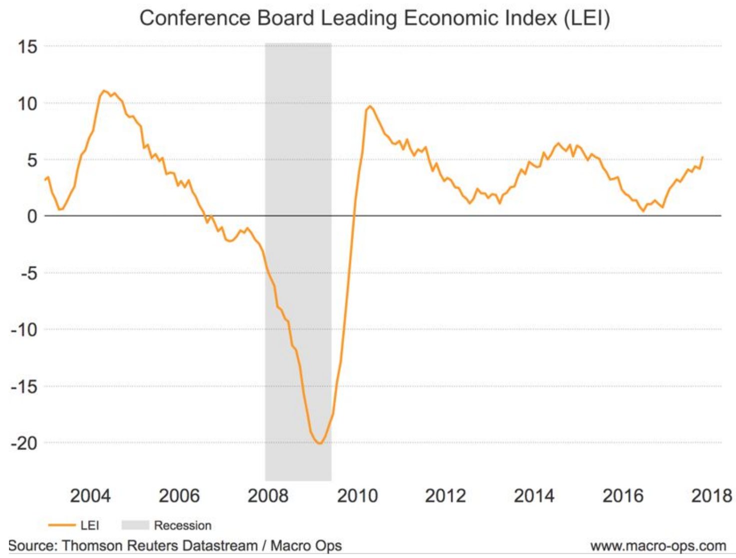
THURSDAY:

BoJ announces its monetary policy decision. No changes to its stimulus program are expected. The Bureau of Economic Analysis releases its final estimate for third-quarter GDP (US). GDP was previously printed at a 3.3% annualized growth rate.



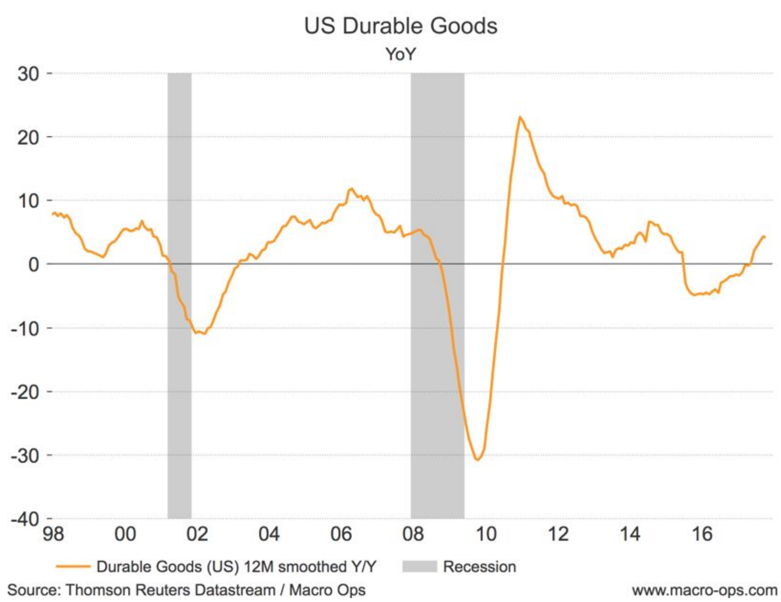
The Conference Board release its index of leading economic indicators (LEIs). These are some of our favorite leading macro indicators and we'll be watching the data closely.

The consensus expects the index to show slower growth of 0.3% versus 1.2% in October. The chart below shows the LEI on Y/Y basis. It's in a strong uptrend, suggesting odds of a recession in the coming 12 months remain very low.



FRIDAY:

Durable goods numbers are reported for November. A large increase is expected on a rebound in aircraft orders. Durable goods have seen a strong rebound (chart below) since the 15'/16' bear market in commodities. Personal income and spending numbers for November also come out.



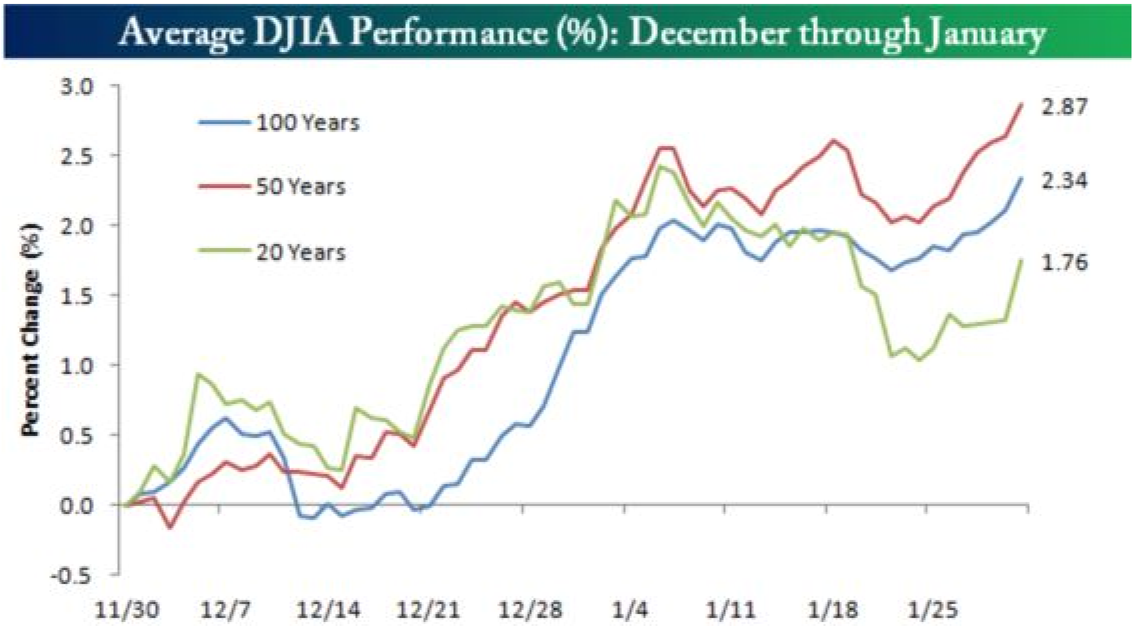
Earnings Releases:

Micron Technologies (MU) reports earnings after the close on Tuesday. I like this name and have been considering putting on a starter position but will wait until after the release.

Interesting Charts:

On Monday we enter what has historically been the strongest two weeks of the year for equities. This period is what's known as the 'Santa Rally'.

According to the Stock Trader's Almanac, the Santa Claus rally "has yielded positive returns in 34 of the past 45 holiday seasons — the last five trading days of the year and the first two trading days after New Year's. The average cumulative return over these days is 1.4%, and returns are positive in each of the seven days of the rally, on average. Nevertheless, each year there is at least one day of declines. Alternative research over a longer period confirms the persistence of these trends. According to historical data going back to 1896, the Dow Jones Industrial Average has gained an average of 1.7% during this seven day trading period, rising 77% of the time."

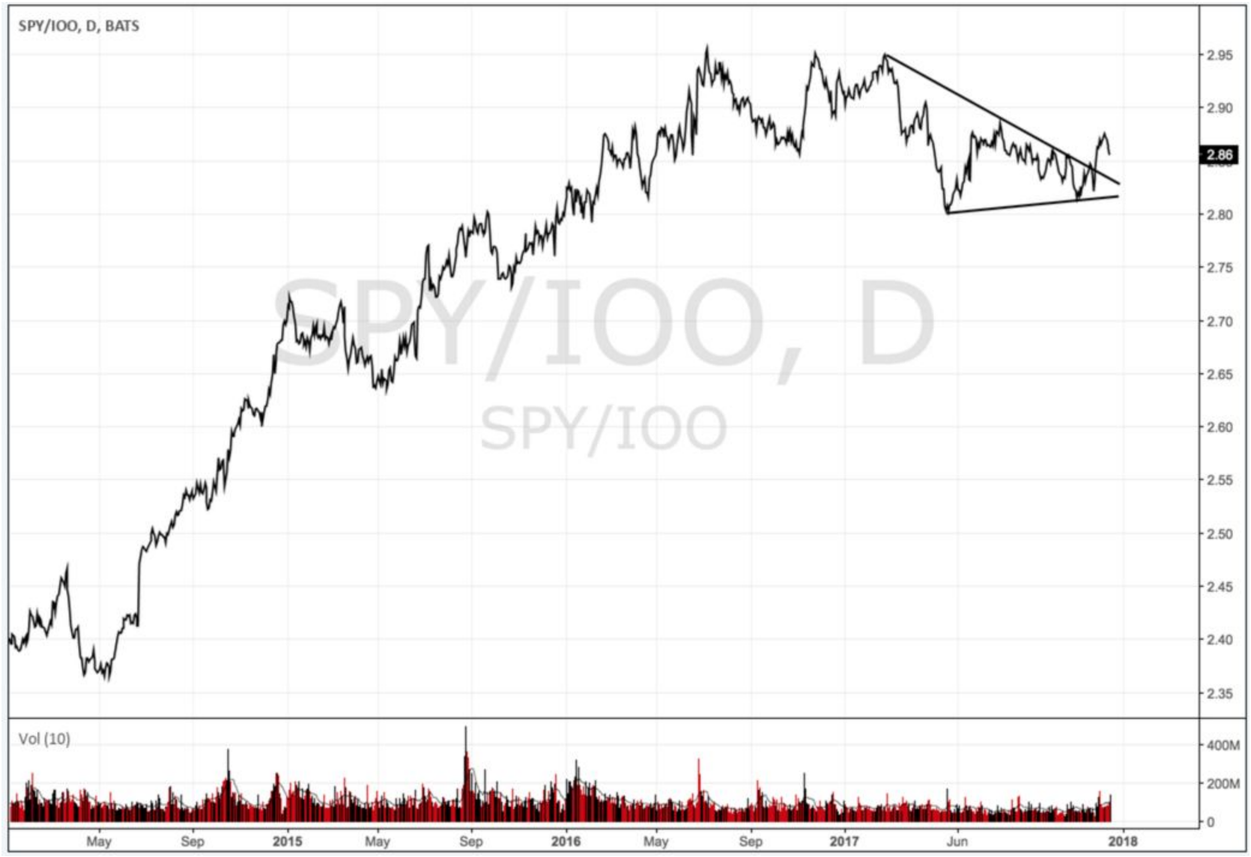


There are a number of reasons for this seasonal effect such as end of year window dressing, HF managers not wanting to be caught with too much cash on their books, holiday illiquidity which makes it easier for bids to have an outsized effect on the market and so on.

I've noticed over the years that speculative small-caps often see large positive gains over this period. There's no way to know if we'll see the Santa effect this year but it's worth being aware of. Tax reform will likely be taking the spotlight this week and will be the deciding factor of whether we see an end of year run up or selloff.

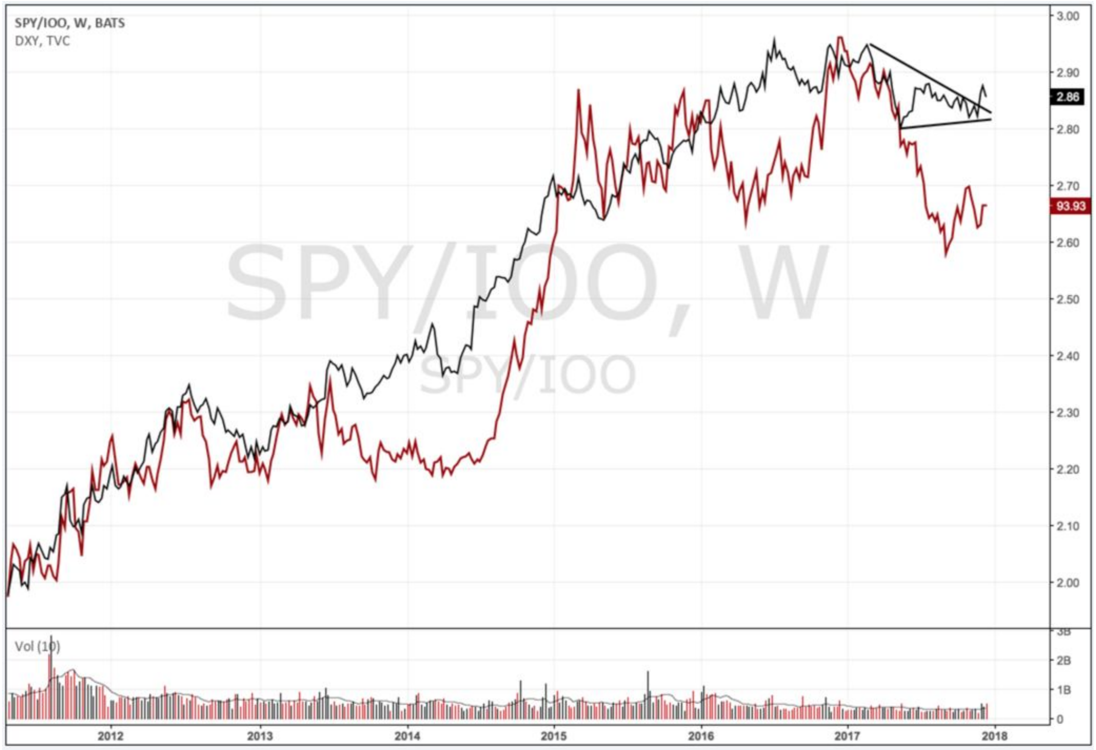
Here's the next chart I'm watching closely. It shows the S&P relative to the rest-of-the-world (ROW). US equities led global equities all cycle until this mid-16' when ROW equities began catching up and then outperforming for most of this year.

But as we can see on the chart below, it looks this period of ROW outperformance might be over.



This is important because capital flows tend to chase relative market performance which creates circular feedback loops of greater relative equity performance attracting more capital flows which drives up the local currency leading to higher total returns thus attracting more capital flows and so on.

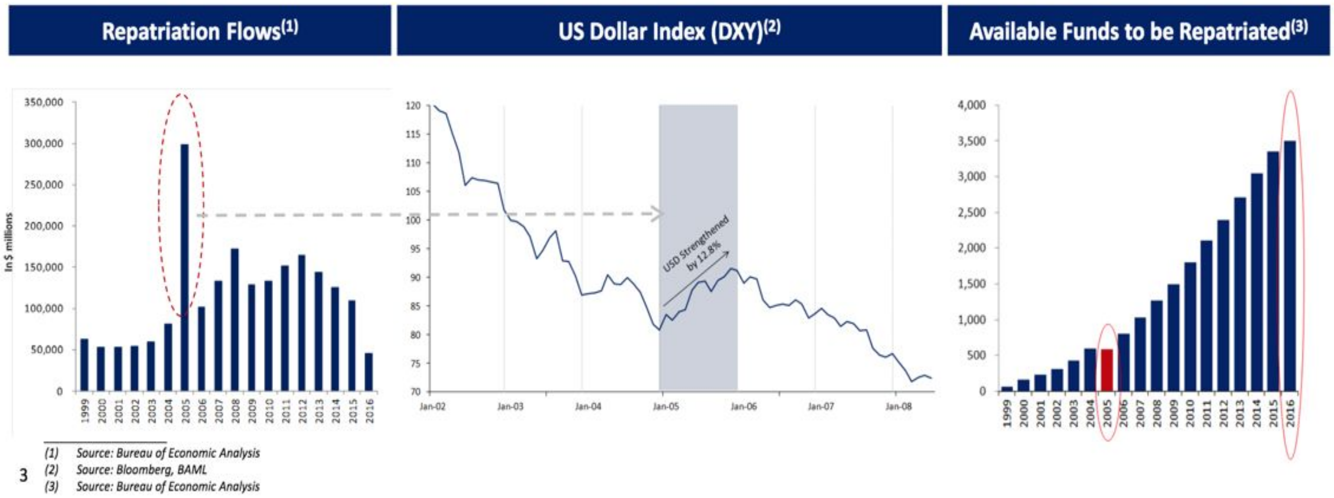
If the US equity market continues this trend of outperformance we should expect the bid to come back into the USD. The correlation between the two can be seen on the chart below (SPY vs. IOO in black and DXY in red).



If tax reform passes, it's likely to supercharge the SPY vs. ROW and bullish dollar trend.

There are two reasons for this (1) the corporate tax cut will significantly boost earnings growth and US equity relative attractiveness versus the ROW and (2) the repatriation of over $2+ trillion in cash held overseas means a huge jump in dollar demand as foreign holdings are converted from their local currencies back into USD.

Check out these charts below from BofA. They show the dollar impact from the last time we saw a large repatriation into the US. This was HIA in 2005, where we saw $300B flow back within the US on a one-time tax holiday. The chart on the right shows how much larger the repatriation this time around is.



I also want to show you these two charts from JPMorgan which show building inflationary pressures in the US economy.

JPM noted the following in their report, “We see signs of incipient inflation in recent data. The Absorption Ratio based on disaggregated inflation data suggests a build-up in inflation as the underlying inflation tendency across various goods and services is increasingly being explained by the top factor i.e. economy wide inflation. Our view is the US will see core inflation rate up by about 0.5% in 2018 (2.3% from 1.8%E Dec-2017). Meanwhile inflation in Eurozone and Japan is expected to remain roughly unchanged.

Rising inflation is the biggest risk to the bull market. It always is. This is because rising inflation causes interest rates to rise, which pulls liquidity from stocks and sparks off a feedback loop that eventually leads to a bear market. So we need to watch this closely.

Lastly, here's a breakdown of equity positioning by players relative to history. Most buyers of equities are maxed out long stocks right now. Just some food for thought going into next year.

Figure 87: Retail Equity Exposure Elevated
Equity assets as percentage of total financial assets

Source: J.P. Morgan US Equity Strategy & Global Quantitative Research, Federal Reserve

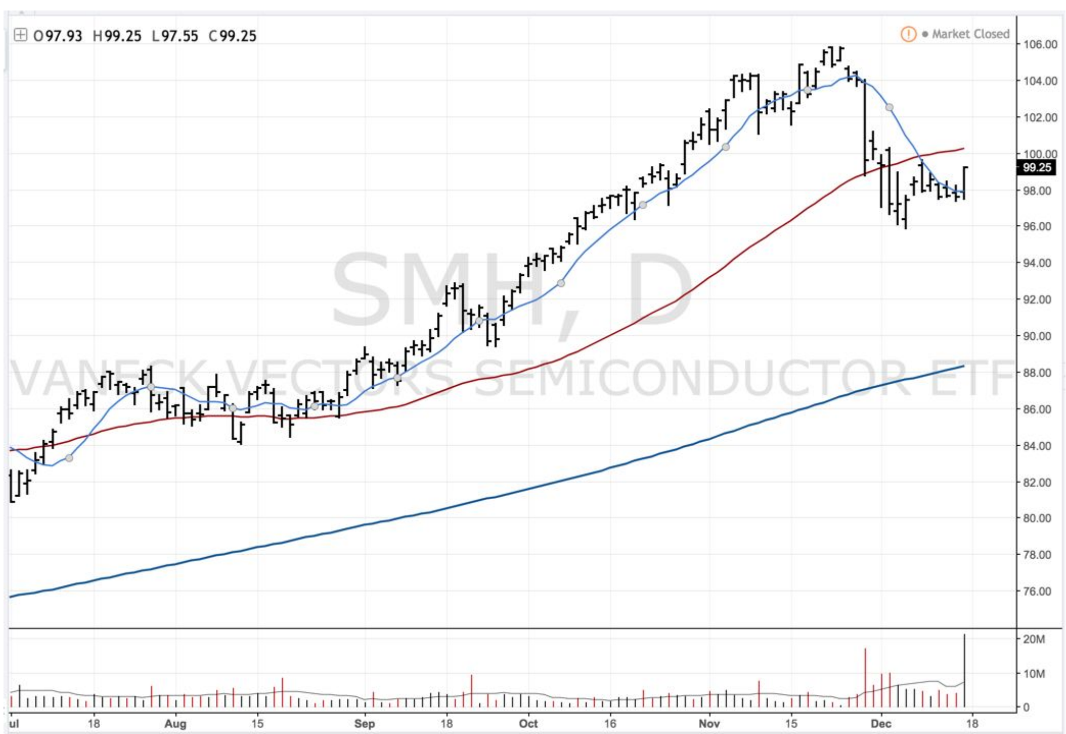
Figure 88: Equity Positioning (Percentile) by Investor Type
Historical time periods for %-iles vary based on data availability

Investor Type	Equity %-ile
Margin Debt / Mkt Cap.	100%
US Households	94%
US Mutual Funds	98%
Pensions	88%
Sov. Wealth Funds	100%
Systematic Strategies	100%
All Hedge Funds	98%
Equity Hedge Funds	93%

Source: J.P. Morgan Macro QDS, report

Target List - Trade setups that might trigger this week:

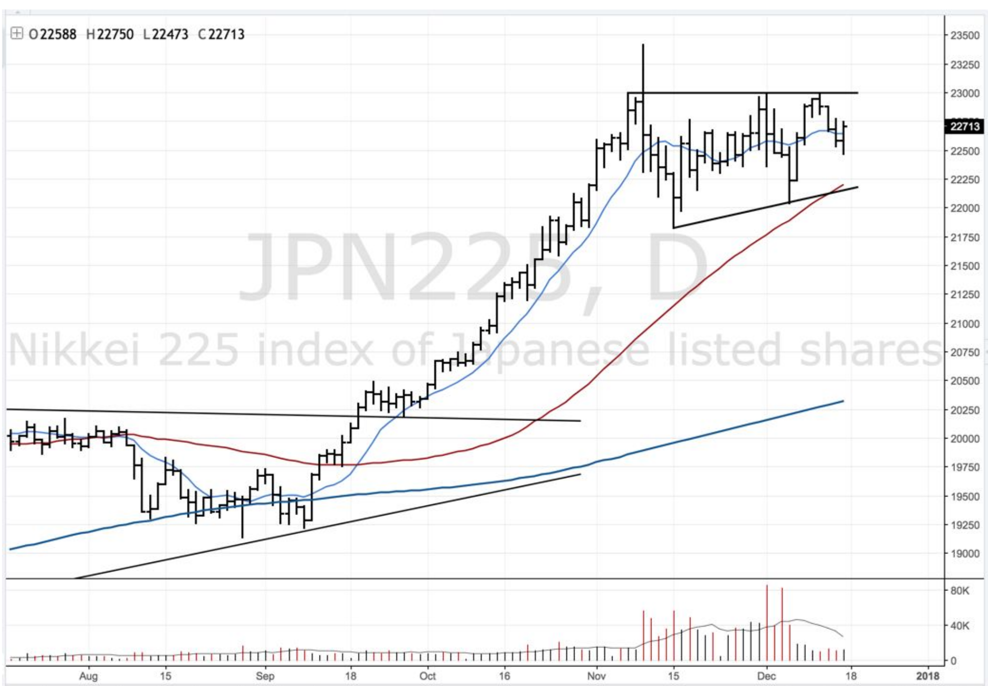
The VanEck semiconductor ETF (SMH) finished Friday on its highs, on huge volume — a very bullish close. This is typically a good bellwether for market risk-on/risk-off.



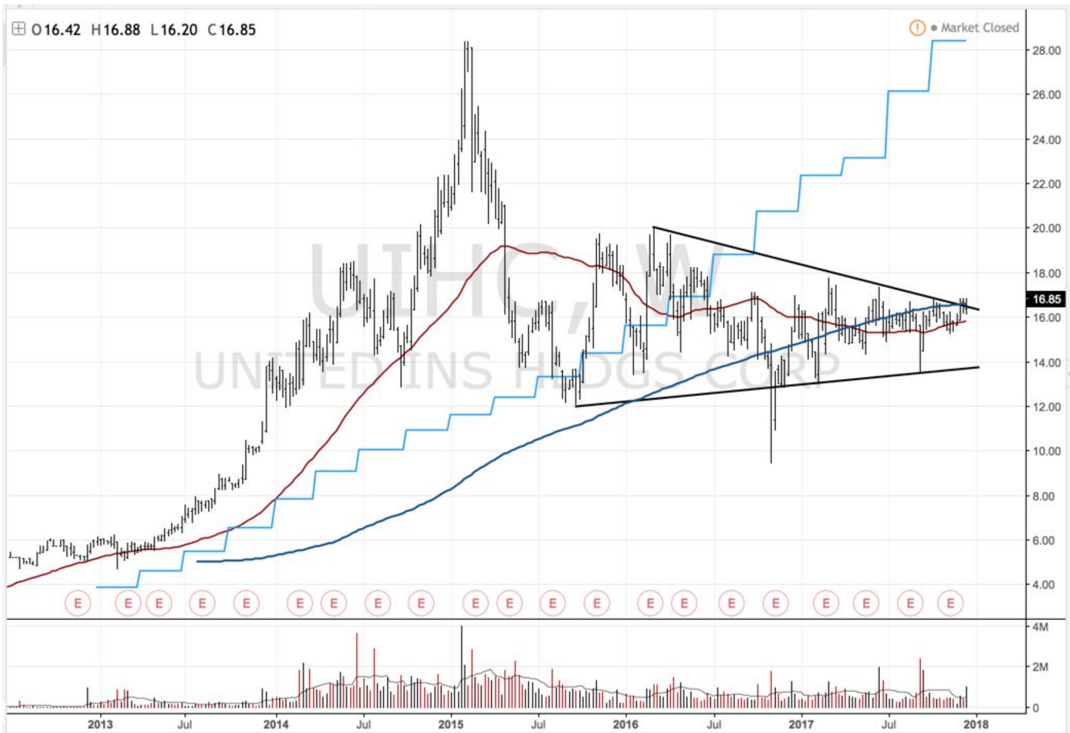
This suggests that we may see the beaten up tech momentum names (SQ, MU, ESIO, KEM) which we covered in last week's Brief, rally into the end of the year. The news that came out today (Sunday) about Senator McCain, could kill this though, so we'll have to see how the market acts Monday.

If we do see a Santa/tax rally it wouldn't be out of the ordinary to see these momentum names go on a vertical run and take out their previous highs by the end of the year.

I'm still considering putting on a position in the Nikkei futures (EWJ is the ETF alternative) this week if the action holds strong. I'd start with a small starter position and then add on a breakout of the current consolidation area.



I’m also looking to put a position on in United Health Holdings (UIHC). I covered this stock in our Friday Macro Musings earlier in the year and have had it on my watchlist since. The blue staircase line is TTM revenues which have been growing at an average annual rate of 38% over the last five years. And this growth isn’t slowing down.



Insiders have been loading up on the stock all year.

Insider Trading	Relationship	Date	Transaction	Cost	#Shares	Value ($)	#Shares Total	SEC Form 4
POITEVINT ALEC II	Director	Dec 15	Buy	16.71	1,500	25,065	1,500	Dec 15 04:57 PM
Hogan Michael	Director	Dec 12	Buy	16.45	2,500	41,125	57,438	Dec 13 04:25 PM
Salmon Kimberly	General Counsel	Sep 07	Buy	14.08	900	12,672	29,622	Sep 07 02:43 PM
POITEVINT ALEC II	Director	May 17	Buy	15.03	3,519	52,897	504,466	May 18 04:01 PM
POITEVINT ALEC II	Director	May 16	Buy	15.00	4,205	63,075	500,947	May 17 04:01 PM
Swenson Andrew	Chief Information Officer	May 12	Buy	15.00	4,000	59,997	31,017	May 12 04:03 PM
POITEVINT ALEC II	Director	Mar 14	Buy	16.05	5,167	82,914	484,466	Mar 15 04:07 PM
Salmon Kimberly	General Counsel	Mar 14	Buy	16.03	1,800	28,854	28,722	Mar 14 04:12 PM
POITEVINT ALEC II	Director	Mar 13	Buy	16.24	22,000	357,238	479,299	Mar 14 04:10 PM
Salmon Kimberly	General Counsel	Mar 13	Buy	16.22	2,000	32,430	26,922	Mar 13 04:03 PM
POITEVINT ALEC II	Director	Mar 13	Buy	16.25	8,273	134,428	18,300	Mar 13 04:02 PM
Menon Deepak	Chief Revenue Officer	Mar 10	Buy	16.25	5,000	81,250	96,322	Mar 10 04:04 PM
Swenson Andrew	Chief Information Officer	Mar 10	Buy	16.33	500	8,165	24,017	Mar 10 04:03 PM
HOOD III WILLIAM H.	Director	Mar 10	Buy	17.00	41,858	711,746	689,191	Mar 16 04:01 PM
POITEVINT ALEC II	Director	Mar 10	Buy	16.25	10,027	162,939	10,027	Mar 13 04:02 PM
Salmon Kimberly	General Counsel	Mar 06	Buy	16.66	5,000	83,300	24,922	Mar 08 04:04 PM
Salmon Kimberly	General Counsel	Mar 01	Buy	16.65	500	8,325	19,922	Mar 03 04:05 PM
HUDSON SHERRILL W	Director	Feb 24	Buy	16.09	13,756	221,337	128,403	Feb 27 04:02 PM
DiFrancesco Paul F	Chief Underwriting Officer	Feb 24	Buy	16.10	2,481	39,932	11,481	Feb 27 04:02 PM
Menon Deepak	Chief Revenue Officer	Feb 24	Buy	16.14	10,000	161,400	93,592	Feb 27 04:03 PM
HUDSON SHERRILL W	Director	Feb 23	Buy	16.11	24,647	397,114	114,647	Feb 24 04:04 PM
Menon Deepak	Chief Revenue Officer	Feb 23	Buy	16.31	10,000	163,100	83,592	Feb 27 04:03 PM

The stock broke out of its 30-month triangle pattern on Friday, on 5x normal volume. If the market is acting right on Monday, I’ll put a full position on in UIHC.

Finally, the Amazon of China, JD.com (JD), is forming a bullish coiling wedge pattern (chart below is a weekly).

We own the Jan 2019 DOTM calls on JD and I've written about the company a number of times. But I'm thinking about writing an in depth follow up because this is my highest conviction equity trade at the moment and the market completely misunderstands it. I think there's potential for this company to be a long-term compounder and 10x'r.

I want to build on our long position, either through more calls or a naked long position. But I will wait for the wedge pattern to complete.

That's it for this week. Shoot us an email if you've got any questions and have a great week in the markets!

Your Macro Operator,

Alex